Internal Revenue Service

memorandum

CC:TL:Br3
AStumpff

date: AUG 15 1991

to: District Counsel
Houston CC:HOU:TL

from: Employee Plans Litigation Counsel

subject: [redacted]

This is in response to your August 6, 1991, memorandum requesting tax litigation advice, in connection with the above-referenced case, as to the proper interpretation of I.R.C. § 412(c)(8) and related regulations. The issue as to which you requested guidance concerns whether a plan amendment adopted during a plan year may be taken into account for purposes of calculating the maximum deductible contribution for that year, under I.R.C. §§ 404 and 412, where no election has been made under § 412(c)(8).

FACTS

The relevant plan year for the plans in question ended [redacted]. In [redacted], the plans were amended to increase the benefits provided thereunder. Although no election was made by the plan sponsors under I.R.C. § 412(c)(8), the plans' actuary took the amendments into account, for purposes of calculating the maximum deductible contribution, as if the amendments were in effect for the whole of the plan year ended [redacted]. If the amendments are taken into account for the whole of the plan year ended [redacted], the maximum contribution deductible by the plan sponsors for the year is $[redacted]. If the amendments are not taken into account at all during the year, the maximum deductible contribution is $[redacted].

DISCUSSION

As noted in your memorandum, the relevant statutory provisions are the following portions of I.R.C. § 412:

I.R.C. § 412(c)(3):

> **Actuarial assumptions must be reasonable.--** For purposes of this section, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods--

09551

> (A) . . . each of which is reasonable . . . or which, in the aggregate, result in a total contribution equivalent to that which would be determined if each such assumption and method were reasonable . . . .

I.R.C. § 412(c)(8):

> Certain retroactive plan amendments.-- For purposes of this section, any amendment applying to a plan year which--
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> (A) is adopted after the close of such plan year but no later than 2 and one-half months after the close of the plan year (or, in the case of a multi-employer plan, no later than 2 years after the close of such plan year),
>
> (B) does not reduce the accrued benefit of any participant determined as of the beginning of the first plan year to which the amendment applies, and
>
> (C) does not reduce the accrued benefit of any participant determined as of the time of adoption except to the extent required by the circumstances,
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> shall, at the election of the plan administrator, be deemed to have been made on the first day of such plan year. . . .

In addition, several regulations and at least one revenue ruling are relevant to the question at hand. First, Treas. Reg. § 11.412(c)-7 restates the election provisions contained in § 412(c)(8) of the Code and sets forth procedures for making the election. Further, Treas. Reg. § 1.412(c)(3)-1(d) provides as follows:

> Prohibited considerations under a reasonable funding method--(1) Anticipated benefit changes--(i) In general. Except as otherwise provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year.

Furthermore, Rev. Rul. 77-2, 1977-1 C.B. 120, contains the following provision:

Section 2.02:

> In the case of a change in the benefit structure that becomes effective as of a date during a plan year (but subsequent to the first day in such plan year), the charges and credits to the funding standard account

> (1) shall not reflect the change in such benefit structure for the portion of such plan year prior to the effective date of such change, and (2) shall reflect the change in such benefit structure for the portion of the plan year subsequent to the effective date of the change.

Section 3:

> In the case of a change in benefit structure that becomes effective in a plan year and that is not adopted on or before the valuation date in such plan year, in lieu of using the rule described in section 2.02 such change in benefit structure may not be considered in determining the charges and the credits to the funding standard account for such plan year. Whichever method is adopted may not be changed for such year once the annual return described in section 6058 of the Code is filed.

As noted in your memorandum, I.R.C. § 412(c)(8) does not on its face apply to plan amendments made during, as opposed to within 2-1/2 months after, a plan year. Thus, although the section contains the negative implication that an amendment adopted during such a 2-1/2 month period must be the subject of an election by the plan sponsor in order to be taken into account for the entire year for funding purposes, the section contains no such implication for amendments made during the year. Nonetheless, in light of the dual function of § 412 in specifying rules for purposes of both minimum and maximum funding, as well as the regulation and revenue ruling cited above, the correct result appears to be that unless an election is made, a plan amendment adopted during a plan year may not be taken into account as if in effect for the entire year unless an election is made in compliance with § 412(c)(8).

Section 2.02 of the revenue ruling partially quoted above appears to be on point and provides, in cases such as the present one, that for funding purposes the plan administrator must take the plan amendment into account only for that portion of the plan year that occurs after the adoption of the amendment.[1] This

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[1]As indicated above, Section 2.02 of Rev. Rul. 77-2 applies to "a change in the benefit structure that <u>becomes effective</u> as of a date during a plan year (but subsequent to the first day in such plan year)." (Emph. added.) Taken literally, this language does <u>not</u> necessarily encompass situations where, as with [redacted], an amendment is <u>adopted</u> in mid-year, with retroactive effect to the first day of the year. Your memorandum raises a similar concern with the nearly identical language -- "become

revenue ruling was apparently not superseded by the promulgation of Treas. Reg. § 1.412(c)(3)-1(d) in 1980. The Service has, for instance, cited the revenue ruling with approval on several occasions since 1980, most recently in Notice 88-131, 1988-2 C.B. 546, 549. The revenue ruling is properly regarded as falling within the introductory language in the regulation authorizing the Commissioner to issue additional guidance.

Thus, considering only Rev. Rul. 77-2 and Treas. Reg. § 1.412(c)(3)-1(d), it would appear that a plan sponsor who adopted an amendment in mid-year should take the amendment into account for funding purposes for that portion of the year occurring after adoption of the amendment. (If the amendment were not adopted prior to the valuation date for the year, the plan sponsor would have a choice, under Section 3 of the revenue ruling, between taking the amendment into account for such portion of the year, or not taking the amendment into account at all during the year.) In the case of [redacted], therefore, the appropriate maximum deduction would be some amount between $[redacted] and $[redacted]. Were the inquiry to end here, however, the paradoxical conclusion would follow that a plan sponsor who adopted an amendment within 2-1/2 months after the end of a plan year could elect, under I.R.C. § 412(c)(8), to take the amendment

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effective" -- contained in Treas Reg. § 1.412(c)(3)-1(d). Further investigation shows, however, that Section 2.02 of the revenue ruling was intended to cover this situation. Section 3 of the revenue ruling explicitly applies to an amendment "that becomes effective in a plan year and that is not adopted on or before the valuation date in such plan year," and provides an alternative, in the case of such an amendment, to the general rule expressed in Section 2.02. Subsequent rulings have also characterized Section 3 as an "exception" to the general rule of Section 2.02, available where the amendment is adopted on or before the valuation date. See, e.g., Rev. Rul 81-215, 1981-2 C.B. 106. This implies that Section 2.02, absent application of Section 3, was intended to apply to amendments adopted during the plan year, regardless of their effective date during the year. Section 2.02 uses the phrase "made effective," rather than "adopted," because the section was intended to be general enough also to cover the circumstances described in Example 1 of the Revenue Ruling, where an amendment is adopted at the beginning of a year, but becomes effective at some later date.

You have also suggested that, even if the term "made effective" in Section 2.02 of the revenue ruling refers to the adoption date of an amendment such as those in question in the [redacted] case, the Section's subsequent use of the term "effective date" may refer instead to the date the amendment is by its terms effective. It seems unlikely, however, that the drafters of the ruling intended the word "effective" to have two different meanings within the same section.

into account for the entire plan year, while a sponsor who adopted the same amendment during the plan year would have no such option. As you suggest, this conclusion seems unacceptable.

One way of resolving this paradox would be to interpret I.R.C. § 412(c)(8) as implying that an amendment made during a plan year is automatically treated as if in effect for the entire plan year. This interpretation would be consistent with the language of the statute, and would cause plan sponsors who adopt an amendment during a plan year to be treated at least as favorably as sponsors who adopt an amendment within 2-1/2 months after the end of the year.

Two major difficulties arise with such an interpretation, however. First, it would render meaningless that portion of Rev. Rul. 77-2 discussed above. Second, and perhaps more fundamentally, while such an interpretation would solve a paradox for purposes of maximum funding calculations, it would create a similar paradox for minimum funding calculations. That is, under this interpretation, for minimum funding purposes plan sponsors would be better served by delaying adoption of amendments increasing plan benefits until after the end of a plan year. This is because an amendment adopted during the year would be automatically treated as in effect throughout the year. In addition to constituting a questionable policy result, this consequence for minimum funding purposes would be contrary to current practice.[2]

In light of these concerns, the interpretation most consistent with the statutory language and relevant regulatory pronouncements is that set forth in Rev. Rul. 77-2, modified so as to permit plan sponsors to make the election described in I.R.C. § 412(c)(8). Thus, for both minimum and maximum funding purposes, assuming no election is made under § 412(c)(8), a plan administrator must treat a plan amendment adopted during a plan year as in effect during the portion of the plan year after adoption. (If the amendment is not adopted by the valuation date, the administrator will have the option, under Section 3 of

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[2]Absent consistent application of Rev. Rul. 77-2 to amendments adopted during a plan year, an even more troubling consequence, from a policy perspective, may result. If Rev. Rul. 77-2 is ignored, a plan sponsor might argue for minimum funding purposes that a benefit-increasing amendment adopted during a plan year, absent an election under I.R.C. § 412(c)(8), should be automatically treated as not in effect throughout the plan year. The Service could potentially be "whip-sawed" between sponsors who for maximum funding purposes treat such an amendment as in effect throughout a plan year, and those who for minimum funding purposes treat such an amendment as not having been effect at all during the plan year.

the revenue ruling, to ignore the amendment entirely for funding purposes for the plan year.) On the other hand, if an election is made in compliance with I.R.C. § 412(c)(8), the plan administrator may, for both minimum and maximum funding purposes, treat the amendment as having been in effect for the whole of the plan year.

While the conclusion reached in the preceding paragraph appears to be the most reasonable interpretation of the Code and other authority, there are obvious hazards associated with pursuing this theory in the present litigation. No one legal authority explicitly states such a rule. (Rev. Rul. 77-2 prescribes the proper funding assumption where no election has been made under I.R.C. § 412(c)(8) has been made, but is silent as to the consequences where such an election has been made.) Examined purely on its face, the relevant statutory provision, § 412(c)(8), is at best silent with regard to the issue of amendments adopted during the plan year, and may contain implications that are harmful to the Service's position.

As you have reminded us, the current case is a complex one, and the Service's principal goal therein is to vindicate other adjustments such as that of the interest rate and mortality assumptions used by the actuary. In light of the weaknesses discussed above, as well as the difficulty and costs (in terms of time and effort, and in terms of diverting attention from the main issues) associated with continuing to press the issue described in this memorandum, we are currently reviewing whether to recommend continued litigation of this issue. In order to provide time for a proper analysis of this question by the technical groups at the National Office, we believe that you should continue to maintain your current posture with respect to this issue. Once a decision is reached (which we anticipate will occur in the near future), we will provide supplemental advice.

If you have any questions, please contact Andrew Stumpff or Patricia Scott-Clayton at FTS 566-4926.

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cc: James E. Holland